Massachusetts Electric
A National Grid Company

Amy G. Rabinowitz
Counsel

October 29, 2001

By Hand

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station, 2nd Floor
Boston, MA 02110

Re: D.T.E. 01-71, Investigation by the Department of Telecommunications and Energy on its own motion, pursuant to G.L. c. 164, Sections 1E, 76 and 93, into the electric distribution companies' quality of electric service, including but not limited to their service quality filings, to be submitted in response to Service Quality Standards for Electric Distribution Companies and Local Gas Distribution Companies, D.T.E. 99-84, and D.T.E. 99-47.

Dear Secretary Cottrell:

Enclosed for filing in the above referenced docket are one original and 14 copies of a settlement agreement (the Settlement) jointly sponsored by the Associated Industries of Massachusetts (AIM), the Attorney General's office (AG), the Division of Energy Resources (DOER), The Energy Consortium (TEC), and Massachusetts Electric Company (Mass. Electric) and Nantucket Electric Company (Nantucket) (Mass. Electric and Nantucket are collectively referred to herein as the Company). The Settlement is designed to revise the service quality plan which was an integral part of the Company's long-term Rate Plan Settlement, dated November 29, 1999, approved in D.T.E. 99-47, relating to the merger of Eastern Edison Company into Mass. Electric, and to resolve all issues presented in this proceeding. Therefore, this Settlement is submitted for approval by the Department in both dockets, D.T.E. 99-47 and D.T.E. 01-71.

Background

The Company's Rate Plan Settlement approved in D.T.E. 99-47 provided the assurance of long-term rate stability by including a five year distribution rate freeze, followed by another five year period when distribution rates would be capped at 90% of the average rates of other Northeastern U.S. electric distribution companies. The Rate Plan Settlement coupled this ten-year rate stability plan

25 Research Drive
Westborough, MA 01582-0099
508.389.2975 Fax: 508.389.3518
amy.rabinowitz@us.ngrid.com

with another plan that was designed to ensure that both reasonable, stable delivery rates and strong service quality were maintained over such a long period of time. This Service Quality Standards (SQS) plan provides for the Company's actual performance in the areas of reliability, line losses, customer service and safety to be compared to historical performance in these same areas. For performance that is below average, the Company accrues penalties to be returned to customers once a specified threshold is exceeded. Similarly, for performance that is above average, the plan provides that the Company will accrue incentives to be collected from customers once the same threshold is exceeded.

The Company's rate stability plan and its SQS plan went into effect on May 1, 2000. For the first partial year, the Company accrued $3.7 million in SQS incentives primarily for above average performance in reliability and customer service. To date, 2001 performance in reliability, customer service and safety have generally been below historical averages and a net penalty of $7 to $9 million will likely accrue for the year. Several factors have contributed to these subpar results for 2001, including unusual weather, increased power supply prices which have increased call volumes, and temporary effects of the Company's transition to an improved system of meter reading . Thus, under the current plan, the Company will likely have accumulated a tally of $3 to $5 million in net penalties by year-end 2001. The current SQS plan provides that, when the cumulative balance of net penalties or incentives exceeds $20 million, customer refunds or surcharges are implemented. In addition, the current plan provides for any net balance of penalties or incentives to be "cashed out" at the end of the SQS plan period in 2009.

On June 29, 2001, the Department established guidelines for SQS with its order in D.T.E. 99-84, calling for any company with an existing SQS plan to file a new plan by October 29, 2001. The Department also ordered any company that submits a SQS plan that deviates from its guidelines to provide full and complete support for its proposal including the reasons for any departures from the guidelines. This filing is designed to meet these requirements.

The Company's current SQS plan also states that the plan shall be subject to modification after the issuance of an order in D.T.E. 99-84. Specifically, the following is an excerpt from pp. 26 & 27 of the Rate Plan Settlement filed and approved in D.T.E. 99-47:

> "(T)he signatories agree that Mass. Electric's Service Quality Plan shall be subject to modification if a generic performance based program is authorized or required by the Department. Accordingly, Mass. Electric shall implement revised performance standards to closely align with any generic performance based program that may be authorized or required

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Westborough, MA 01582-0099
508.389.2975 Fax: 508.389.3518
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> by the Department during the Rate Period. Mass. Electric will consult with the parties prior to filing any such revision to this Plan and the parties agree that they will work together to develop a proposal before the Department. If the revised standards would result in a significant difference in the balance of risks, costs and benefits set forth in [the current SQS], the quantified differences shall be recognized as an Exogenous Factor . . . ."

Revised SQS Plan

In many respects, the Company's current SQS plan already contains most of the features of the Department's final guidelines; nevertheless, the parties agreed that it was critical to better align the current plan with the new guidelines. Since May 2000, the Company has been abiding by a plan which contained six of the Department's eight recommended performance measures. Furthermore, the current plan has a significant (40%) weighting of reliability measures (outage frequency and duration), virtually identical to the Department's recommended 45% weighting of the very same measures. As a result of the Department's recent order and the terms of the Rate Plan Settlement, however, the Company has worked together with the settlement parties to develop a proposed revised SQS plan (the Revised SQS Plan) and is pleased to submit the enclosed Settlement which incorporates the plan.

Alignment with the Department's Guidelines

As provided in Attachment 10a to the Settlement, the Company proposes to revise its SQS plan to closely align with Department's new guidelines. The following changes have been made to better align with the new guidelines:

1. Two new performance measures are incorporated:
    a. Service appointments met
        Although the Company proposes to include this measure, no historical data is currently available. Therefore, this measure will be incorporated in the Company's SQS plan after data is available for three years in 2005.[1]
    b. Billing adjustments

[1] The parties to the Settlement have agreed to the deferred implementation of this standard as a special situation that does not set any precedent for the future or in any other case.

25 Research Drive
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For this performance measure, the Company proposes to incorporate a mechanism that is designed to adjust each year's historical dollar amount of billing adjustments per 1,000 residential customers by the mid-year average residential bill in each year. This avoids a performance standard that would penalize the Company when the average bill amount increases. See specific language in Attachment 10a.

2. Three performance measures are eliminated from the current SQS plan:
   a. Customer satisfaction survey results
   b. Customer contact survey results
   c. Restricted work case rate
3. The weighting of performance measures is adjusted as shown in Attachment 1.
4. Six (6) years of data (1996-2001) are used for the initial reliability benchmarks
5. Ten years of data (where available) are used for other benchmarks
6. The maximum annual penalty amount is annually adjusted to 2% of T&D revenues
7. The Department's methodology is used to determine the amount of the annual penalty. For example,
   a. No penalty is assessed when actual performance falls within one standard deviation of the historical performance mean
   b. The maximum penalty is assessed when actual performance is two or more standard deviations from the historical mean
   c. For actual performance between one and two standard deviations from the historical mean, the Department's non-linear formula is used to determine the penalty

Departure from the Department's Guidelines

As described below, certain provisions of the Company's Revised SQS Plan differ from the Department's new guidelines. Specifically, the Revised SQS Plan deviates from the guidelines in the following areas:

1. *In the case of consistently poor reliability performance, it provides for a doubling of the maximum penalty* and a prompt payout of such penalty to customers.
2. *The maximum aggregate penalties under the plan are not reduced by the amount of*

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the Company's service guarantee payments to customers.
3. The plan continues to allow both penalties *and incentives* to accrue.
4. *It provides for net penalties and incentives to be carried forward from year to year until a balance of $20 million is reached, when excess amounts above the $20 millon are refunded or collected.* After 2009, any remaining balance is refunded or collected.
5. The plan continues to include one performance measure not currently included in the Department's new guidelines. *Distribution line losses* continues as a measure, carrying a 5% weighting.
6. *The historical benchmark is updated each year* rather than being fixed for the term of the SQS plan; however, the standard that triggers the maximum penalty is never lowered.
7. The plan continues to be *a long-term SQS plan (8 more years beyond the first two)*, rather than a three year plan.

In addition, the Company is proposing to maintain the terms of its current SQS plan through the end of this calendar year. This allows for an orderly transition to the provisions of the Revised SQS Plan in 2002. Furthermore, as mentioned above, the Company will likely have accumulated $3 to $5 million in net penalties by year-end 2001 that will be carried forward into the Revised SQS Plan.

A comparison of the performance standards, weightings and potential penalties and incentives from the Company's current SQS plan and the Revised Plan is shown in Attachment 1 hereto.

Information on the historic values for each of the proposed performance measures is contained in Attachment 10b to the Revised SQS Plan.

The Company is in the process of implementing the service guarantee provisions contained in the Department's order in D.T.E. 99-84 and the Company plans to complete the implementation by January 1, 2002.

In its September 28, 2001 order in D.T.E. 99-84, "(t)he Department directs distribution companies to submit SQ plans with staffing level benchmarks based on staffing levels in existence on November 1, 1997, except as provided by collective bargaining agreements or other statutory provisions." Seven of the Company's eight collective bargaining agreements state that the Company

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has satisfied "all requirements of the Electricity Restructuring Act of 1997, including [M.G.L. Chapter 164,] Section 1E related to staffing levels . . . and that this agreement is a collective bargaining agreement under that language." The remaining agreement states that the union "agrees, for itself and its members, not to hinder or interfere with the management of the Company . . .. on any matter not otherwise specifically addressed in this agreement, including, but not limited to actions related to the following matters: selection of the workforce, including the criteria on which those decisions are based; assignment of the work; direction of the work force; scheduling; *staffing levels*; discipline or discharges for proper cause; and the right to transfer employees to work for which they are better suited and *to furlough employees for any reason, including lack of work or efficiency in operations*." (emphasis supplied) Those provisions in the Company's collective bargaining agreements meet the requirements of M.G.L. Chapter 164, Section 1E. Therefore, no further review of staffing levels is required.

Benefits of our Revised SQS Plan

The Company's proposal is designed to implement a mechanism that both encourages the Company to constantly improve its service and, at the same time, allows exacting regulation of the distribution business. The plan is intended to produce results for our regulated distribution business like those that would be experienced by any business that is subject to competitive market forces. For example, in a competitive marketplace, companies that provide good, reliable service are more profitable than companies that have poor service quality. In the absence of competition, regulation is necessary to send the right signals, rewarding stellar performance while penalizing poor performance. The Company's plan provides such a balanced regulatory mechanism.

The Settlement parties strongly support a plan which shifts the Company's focus beyond penalty avoidance towards continuous improvement. A "penalties only" plan, as contained in the Department's guidelines, encourages actions to stay out of a penalty situation, but does not encourage continued improvement beyond average performance. In fact, companies can avoid any SQS penalty just by maintaining performance that is one standard deviation worse than the historical average. The Revised SQS Plan holds out the promise of incentives to encourage the pursuit of service quality excellence.

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A long-term plan with both incentives and penalties and a threshold that must be reached before it triggers surcharges or refunds offers several benefits. With this long-term penalty and reward system in place, long-term cost-effective service quality improvements are encouraged. The Company's ongoing, multi-year project to automate meter reading equipment and systems is an example of a project that was undertaken to support long-term sustained excellent service quality, with predictable short-term impacts on on-cycle meter reads and customer call volume such as have been experienced in 2001. The Company undertook the project expecting it could result in penalties in the short-term to be offset by incentives once the new system is complete in early 2003. A "penalties only" system would discourage such projects since short-term impacts could not be offset by long-term gains. This is particularly important when a company, like the Company, has left cost-of-service ratemaking and agreed to a long-run rate cap with assurances of below average rates. The balance of penalties and rewards is critical to incentive long-run investments under such a rate plan.

Such a long-term SQS plan incentivizes continuous improvement. Performance-based rates and incentives will encourage long-term strategies to lower cost and improve service. The provisions relating to the threshold before refunds or surcharges are implemented will promote rate stability. For example, the random nature of certain factors affecting performance, which can sometimes yield a strong performance year followed by a weak performance year, tend to cancel each other out and do not lead to a rate surcharge one year followed by a credit the next. In the event that the Company demonstrates consistently poor reliability performance triggering a doubling of penalties, however, the plan calls for such penalties to be promptly paid to customers.

With respect to the maximum amount of potential penalties, the proposed plan goes beyond the Department's guidelines and even beyond the statute. While M.G.L. Chapter 164, Section 1E authorizes the Department to levy a maximum penalty of two percent of the Company's transmission and distribution revenues for poor performance, the Company's plan provides for the doubling of the maximum penalty for poor reliability performance. Effectively, this results in a maximum possible penalty under the Company's plan of three percent of T&D revenues. Furthermore, the Department allows the Company to deduct the amount of any service guarantee payments made to customers from such maximum aggregate penalty. The Company's plan includes no such reduction of its maximum penalties.

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In short, the Company's plan with potential annual penalties of about three percent of T&D revenues (about $19 million) and potential annual incentives of two percent of T&D revenues (about $13 million) puts considerably more (about $32 million) at stake for the Company than under the Department's guidelines. Indeed, the plan puts 2-1/2 times more at stake financially than would be required under the guidelines.

The Company believes that the Department has the authority to approve the Settlement and its Revised SQS Plan under its general ratemaking jurisdiction and under the provisions of the Massachusetts Restructuring Act (the "Act"). The Department has frequently exercised its authority applying an early form of performance-based ratemaking by awarding higher or lower returns on equity to utilities that have demonstrated superior or inferior performance. See Order dated September 30, 1992 in D.P.U. 92-78, p. 115 and Order dated June 26, 1986, in D.P.U. 85-266-A, pp. 13-14, 172-173. It is just such a regulatory mechanism that the Revised SQS Plan is designed to provide based on actual performance of the Company. Indeed, an incentive/penalty mechanism like that contained in the Revised SQS Plan is the only way to send the proper economic signals to a company that has entered into a long-term performance-based rate plan like that approved by the Department in D.T.E. 99-47.

The only provision in the Revised SQS Plan that goes beyond the Act is the one that provides for a doubling of certain penalties in the event of consistently poor reliability performance. However, in this instance, the only party with standing to object to this penalty, the Company, has voluntarily agreed to such doubling as part of a comprehensive Settlement.

The Company's Revised SQS Plan raises the standards each year. While the Department has proposed that the benchmark for future performance be fixed (using data from either a fixed five- or ten-year historical period) during the proposed three-year term of a SQS plan, the Company's plan calls for the benchmark to be updated each year, constantly raising the bar when performance is improving. This will ensure that the Company will be constantly seeking service quality improvements, further raising the bar each year. In fact, the Company's plan ensures that, if historical average performance in any measure falls after the first year of the plan, the maximum penalty is triggered when actual performance falls below the *original* trigger point for the maximum penalty. This provision ensures that the bar triggering the maximum performance penalty is never lowered.

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A balanced long-term SQS plan, with both incentives and penalties, was a cornerstone of the Company's long-term rate stabilization plan. Without the key provisions of a long-term SQS plan, the Company may have sought significantly different terms in other aspects of its Rate Plan Settlement. Under this innovative, long-term performance-based rate plan, the Company's rates are frozen (absent an Exogenous Factor) for five years and subject to a relative rate cap for another five years, while the Company's attention to service quality is strongly encouraged through a balanced SQS plan.

While the Rate Plan Settlement recognized that the Department was investigating the establishment of guidelines for a generic SQS program and the need to revise the Company's plan to closely align to such guidelines, as noted in the excerpt from the Rate Plan Settlement recited above, the specific provisions of the Company's rate agreement made the critical nature of the SQS plan clear; however, the parties to this Settlement and the Rate Plan Settlement support the notion that focusing their efforts on reshaping the SQS plan to more closely align with the Department's new guidelines, but including important measures that go even further, is a much more productive undertaking than arguing over how much an Exogenous Factor has increased costs to the Company. In fact, the Settlement specifically states that the Company will waive any rights that it has to claim that the changes in the Revised SQS Plan constitute an Exogenous Factor, the costs of which the Company would seek to recover through rates.

The Company's Rate Plan Settlement with its long-term rate stability should overcome any gaming concerns. With limited ability to raise rates over the next eight years, concerns that the Company would spend money unwisely just to pocket incentives are unfounded. Any cost of service rate case seeking to recover such extra spending prior to 2010 is unlikely.

The Settlement parties also feel that the Company should be properly motivated to minimize distribution line losses. With historical average distribution line losses of about 4%, the parties were adamant that this performance factor with its significant affect on customers' costs should be included. The parties acknowledge the impact on line losses from loads and the Revised SQS plan acknowledges that the Company may propose an adjustment to this performance standard that removes or normalizes such effects. While distribution losses are not explicitly included in G.L. Chapter 164, Section 1E(a), the list of those standards that are included follows the words "including, but not limited to," in that section, which clearly leaves the inclusion of this or any other standard in the discretion of the

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Department.

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Conclusion

For all of the above reasons, the settling parties respectfully request that the Department approve the Settlement and its Revised SQS Plan under G.L. Chapter 164, Sections 96 and 1E, effective January 1, 2002.

Very truly yours,

Amy G. Rabinowitz

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508.389.2975 Fax: 508.389.3518
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